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C O N F I D E N T I A L SECTION 01 OF 04 PRAGUE 001402

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TAGS: [ENRG](#) [ECON](#) [EFIN](#) [ETRD](#) [PGOV](#) [EZ](#)

SUBJECT: CZECH ENERGY SECURITY: MODERATE BUT INCREASING RUSSIAN FOOTPRINT

REF: A. PRAGUE 256

[1](#)B. BRATISLAVA 870

Classified By: Political-Economic Counselor Michael Dodman
for Reasons 1.4 (b) + (d)

[11.](#) (C) SUMMARY AND COMMENT: The Czech Republic is moderately dependent on Russian oil and gas compared to other former Soviet bloc countries, thanks to its domestic coal production supplying over 50% of domestic energy needs, its position as a major electricity exporter in Europe, and diversified oil and gas supplies. In addition to oil and gas from Russia, the Czech Republic receives oil from the Middle East and gas from Norway. Oil and gas each make up 20% of Czech domestic energy consumption, compared to the EU's combined energy consumption of 43% oil and 24% natural gas. Nevertheless, approximately 70% of Czech oil and gas supply comes from Russia, and Russian footprint in these sectors threatens to grow. The threat takes several forms: (1) direct pressure from Russia to have the Czech government sign MOUs to enhance Russian leverage in the oil and gas sectors (para 9); (2) the continued debate about reversing the direction of the Ingolstadt pipeline so that instead of transporting Middle Eastern oil for domestic consumption, it can become a transit pipeline carrying Russian oil for German consumption (paras 10-11); (3) rumors that ConocoPhillips may sell its 16.3% stake in the biggest Czech oil refining company to Russia's Lukoil (para 12); (4) the majority-government owned electricity company CEZ's decision to import 100% of its nuclear fuel from Russia (para 13); (5) the potential impact of Russia claiming 49% of Slovak oil company Transpetrol which transports Russian oil to the Czech Republic (ref B).

[12.](#) (C) SUMMARY AND COMMENT CONTINUED: Consequently, both during the former Ambassador's mid-September farewell call and the current Ambassador's mid-October introductory call on PM Topolanek, Topolanek raised his concerns about increasing Russian influence on the Czech energy sector. Despite such high-level concerns, research for this cable revealed that the energy sector is highly decentralized, lacking in transparency, and no one person in the government seems to have a handle on all the players and the details. Perhaps in recognition of this reality, the GOCR recently created the position of Ambassador-at-Large for energy security issues, who is overseeing the drafting of an energy security strategy paper, which will be submitted to the State Security Council by end-November with possible approval by January 2007. The paper outlines the lack of emergency gas reserves as the key short-term risk, supply disruptions resulting from pipeline

infrastructure degradation as the key medium-term risk, and Russia signing more contracts than it can supply as the key long-term risk. The Czech MFA believes that addressing the short-term risk is entirely up to the GOCR, while addressing the medium-term and long-term risks requires coordination among all EU countries and with the USG. Meanwhile, in the absence of a national energy security strategy that is effectively implemented, commercial and bureaucratic decisions have and may continue to increase Russian influence in the Czech energy sector and erode Czech energy security. END SUMMARY AND COMMENT.

-- THE ANATOMY OF CZECH OIL AND GAS SECTORS --

¶3. (C) In 2005, Czech energy supply consisted of 51% solid fuels (mainly brown coal), 20% natural gas, 20% liquid fuels (mainly crude oil), and 9% primary electricity and heating (water and nuclear power plants). 100% of Czech solid fuel consumption is supplied domestically and the Czech Republic is one of the major exporters of electricity in Europe, thanks to its two nuclear power plants (ref A). Therefore, Czech dependence on Russian energy is based on its oil and gas consumption, 70% of which relies on Russian imports, as well as what will soon be 100% nuclear fuel imports from Russia.

¶4. (C) GAS INDUSTRY FULLY PRIVATIZED: The Czech government believes its greatest short-term energy supply vulnerability is its lack of emergency gas reserves. The Czech gas sector is 100% privatized and natural gas purchase, transit and storage is based on long-term contracts between German-owned RWE Transgas and Russian company Gazexport (expire in 2013) and six Norwegian producers (expire in 2017). The Norwegian gas is supplied via Germany through the Verbundsnets Gas AG (VNG) pipeline that ends at Hora Svate Kateriny in the Czech

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Republic. The Russian gas is supplied via a pipeline that transits Slovakia and the Czech Republic en route to Germany.

The government does not have any strategic influence on how Transgas conducts business, nor does it have any influence over the terms of its long-term contracts. The Czech MFA believes the current coziness between Germany and Russia further negates any potential influence the Czech government could have in the gas industry. However, the fact that the Czech Republic serves as a transit country for Russian gas supplies to Germany means it enjoys important protection from possible supply disruptions as those experienced by countries with less-advantageous geography. Prague Security Studies Institute Director Jiri Schneider believes this geographic protection is limited since the Czech Republic is not the only gas transit route for Germany, and Russian gas can be diverted in the medium to long term for better prospects east (China) or for growing domestic consumption in Russia.

¶5. (C) TWO OIL PIPELINES EQUALS DIVERSITY: There are two oil pipelines supplying the Czech Republic with a total capacity of 19 million Tons (mT), only 9 mT of which the Czech Republic currently uses, according to state oil company MERO.

The Druzba II pipeline (9 mT capacity vs. 5.2 mT used in 2005) carries Russian oil via Slovakia and ends in the Czech Republic. The Ingolstadt (IKL) pipeline (10 mT capacity vs. 2.7 mT used in 2005) runs from Bavaria to Bohemia; oil delivered via the IKL generally originates in the Middle East and is offloaded at the Port of Trieste. A frequently stated statistic is that if the Druzba II pipeline were shut off, the entire amount could be made up via the IKL pipeline given its existing excess capacity. However, there would be financial implications since there is a significant price difference between the cheaper and more sour oil coming via Druzba and the oil via IKL. Ceska Rafinerska CEO Ivan Soucek explained that if the Druzba II pipeline were shut down, IKL can make up 60% of that within 90-days (note: Czech oil reserves = 90-days per EU requirement).

¶6. (U) STATE-OWNED OIL COMPANY MERO: MERO owns and operates

the Czech portion of the Druzba II pipeline and the IKL pipeline. According to Operations Manager Ondrej Smolik, the Druzba II pipeline underwent a complete upgrade in 2005 (SCADA control system, exchange of 15 line valves, 3 pump stations and 3 terminals). MERO reports to the former National Property Fund (FNM), the government body that was in charge of implementing privatization of state-owned enterprises but no longer exists as an independent entity and has been brought under the Ministry of Finance. Smolik said it was watching developments in Slovakia's Transpetrol case, and that MERO had expressed interest in buying the 49% Yukos share because of beneficial synergistic effect and energy security enhancement for the Czech Republic.

¶7. (C) THREE OIL REFINERIES: There are three oil refineries in the Czech Republic with a total refining capacity of 9 mT: (1) Litvinov (built in 1944 at 5 mT capacity) (2) Kralupy nad Vltavou (built in 1975 at 3 mT capacity), (3) Pardubice (1 mT capacity). The first two are operated by Ceska Rafinerska (CRC), established in 1995 and 51% owned by Unipetrol (a Czech petrochemical company currently under investigation for corruption during its privatization and whose majority shareholder (64%) is the Polish company PKN Orlen) and 49% by three major foreign investors ConocoPhillips, Agip and Shell (each with 16.33%). The third refinery in Pardubice is operated by Paramo, which is 74% owned by Unipetrol, with the remaining 26% owned by minority shareholders. The four oil companies that own the two Czech refineries (Unipetrol, ConocoPhillips, Shell, and Agip) each buy crude oil on the spot market.

¶8. (C) OIL STORAGE CAPACITY: As mandated by the EU, the Czech Republic keeps a 90-day emergency oil supply equal to about 2 mT. MERO, which is responsible for the crude oil reserves, operates a tank farm in Nelahozeves, where there are 14 tanks in operation, including the four biggest tanks in continental Europe with 125 cubic meters each. Two additional tanks are currently under construction to cope with increasing domestic consumption and are expected to be completed in 2008. CEPRO, a state-owned company handling the sale and transport of oil products, has the contract for reserves of refined oil. CEPRO has long been a target of corruption allegations, and some industry observers have suggested that CEPRO has speculated with its portion of the state reserves. The State Material Reserves Administration, which reports to the

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Ministry of Industry and Trade, is responsible for monitoring the oil market and the emergency oil reserves, but the state-owned companies MERO and CEPRO actually hold the reserves of both crude and refined oil.

-- HOW RUSSIAN INFLUENCE CAN INCREASE --

¶9. (C) DIRECT PRESSURE FROM RUSSIA: According to MERO, even though the four private oil companies purchase crude oil directly on the spot market, there is an ambiguous Memorandum of Agreement between the Government of the Czech Republic and the Government of Russia regarding oil supplies dating from 1994. In September, the GOR proposed two new MOUs -- one on crude oil transit and the other on increased gas deliveries -- both of which the GOCR rejected in mid-October. The MFA opposed the MOUs because it would mean the reversal of the IKL pipeline (see para 10) and because gas transit is already occurring without any GOCR involvement. When asked about the significance of these proposed MOUs given existing commercial contracts for both oil and gas, MFA Security Policy Department Director Veronika Kuchynova-Smiglova surmised that Russia is looking for increased leverage in the Czech Republic, and if anything went wrong with commercial contracts, the Russian government can try to involve the Czech government.

¶10. (C) IKL REVERSAL: One key issue is the role of the Ingolstadt (IKL) oil pipeline, which the Czech Republic built in 1995 precisely to enhance the country's energy security.

For some time, the Russians have been proposing reversing the flow of the IKL pipeline so that instead of transporting oil for domestic consumption, it can serve as a transit pipeline transporting Russian oil for German consumption. While staunch opponents such as the MFA argue this would be strategically stupid move from the energy security perspective, those supporting it do so based on commercial interests (i.e., transit fee prospects) and comfort with doing business with the Russians (i.e., the Ministry of Industry and Trade. The MFA argues that if the GOCR wants to become a transit country, it should build a pipeline parallel to IKL and not reverse IKL.

¶11. (C) According to Czech oil company MERO Operations Manager Smolik, it would take about three years to reverse the direction of flow of the IKL pipeline. He explained that necessary technical preparations alone would take 1.5 years, but there was also time required for Germany and Russia at the two ends of the pipeline to sign a letter of intent, followed by one year of "necessary observation." Smolik told econoff that in anticipation of possible future reversal of the IKL pipeline, all planned infrastructure upgrades include reverse technology. For example, the pumping station at Benesovice to be completed in 2007 will have reverse pumping capacity and the new pipeline control system to be completed in March 2008 will have a reverse operation system. Smolik confirmed that the Ministry of Industry and Trade had previously asked MERO to look into the possibility of IKL reversal and that there had been particularly strong interest in this possibility between 1999-2003 when Czech consumption was relatively low with significant excess capacity. MERO was keen on business possibilities then, but Smolik admitted that these days, IKL reversal was no longer a priority for MERO, which has several current projects dealing with the increase in domestic oil consumption.

¶12. (C) CONOCOPHILLIPS SELLING TO LUKOIL?: On September 27, the press (including Dow Jones Business News) reported that Russian company Lukoil was considering a buyout of ConocoPhillips' 16.3% stake in the Czech refinery Ceska Rafinerska (CRC), and that Czech petrochemical company Unipetrol (current majority owner of CRC) is also interested.

(NOTE: ConocoPhillips owns 19.5% of Lukoil. END NOTE) ConocoPhillips Managing Director for Central and Eastern Europe Greg Hart (please protect) told econoff October 17 that the information was likely a leak from Lukoil and that he would know better by end-November what the likely outcome will be on whether ConocoPhillips will sell its share and to whom. He also informed that existing CRC shareholders (Unipetrol, Shell, Agip) have the pre-emptive right to match or beat whatever offer is made by an outside bidder. When asked why ConocoPhillips was considering selling its shares in CRC, Hart pointed to the "lukewarm relationship" with Unipetrol, whose majority shareholder is Polish company PKN Orlen, and with whom ConocoPhillips recently settled out of

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court for charges that PKN Orlen reneged on its agreement to include ConocoPhillips in its bid for majority stakes in the privatization of Unipetrol. In addition to difficulties with Unipetrol, Hart cited increasing business costs (e.g. real estate and wages) and inefficiencies in existing refining infrastructure as reasons for possible departure from the Czech market.

¶13. (C) RUSSIAN NUCLEAR FUEL: On March 17, 2006, the Russian corporation TVEL won the majority-state-owned electricity company CEZ's international tender for fuel deliveries for the Czech Republic's nuclear power plant Temelin, effective ¶12010. Westinghouse Electric (which belongs to British Nuclear Fuels) is currently supplying Temelin. TVEL already supplies the other nuclear plant at Dukovany and will, therefore, have a lock on supplies for all Czech nuclear production. Another Russian footprint in the nuclear energy field is the Russian firm OMZ's ownership of Skoda Nuclear Engineering.

¶14. (C) The MFA's Security Policy Department is in the process of drafting an interagency paper on energy security for the State Security Council (BRS). Due to the on-going political stalemate, the BRS met in mid-October for the first time since May. The energy security paper is due by end-November and the MFA hopes it will be approved by January 2007. The paper specifically identifies "Russian energy imperialism" as a key factor threatening Czech energy security. It outlines measures the GOCR can take to enhance its energy security, including: (1) diversification of nuclear fuel sources; (2) finding a way to have emergency gas reserves; (3) a recommendation against fast privatization of majority stake in electricity company CEZ; (4) supporting partial European continental infrastructure projects for interconnecting oil and gas pipeline networks to increase their transportation capacities; (5) a recommendation against reversing the IKL pipeline "under any circumstances." The paper also recommends the creation of a Foreign Security Policy Coordination Committee Energy Security Working Group for the purpose of information gathering, increasing awareness of the connection between energy and security, and preventing decisions at lower bureaucratic levels that are unaware of political and security connections and impacts.

¶15. (C) The MFA has also created the position of Ambassador-at-Large for Energy Security, recently filled by Eastern European expert and former student dissident Vaclav Bartuska. Bartuska informed econoff October 27 that the energy security paper will also contain a list of key energy security risks. The risks are broken down by short, medium and long-term vulnerabilities. Short-term risks include: (1) the possibility (but not seen as likely) that Russia will cut off its gas or oil supplies to the Czech Republic; (2) the probability that RWE Transgas will sell its gas reserves to the highest bidder and leave the Czech cold in the event of an emergency. The primary medium-term risk has to do with pipeline infrastructure maintenance along the Druzba II and the possibility of technical failure in Russia or anywhere along the pipeline. In the long-term, the great concern is that Russia is over-extending itself in terms of the number of contracts it has signed versus proven reserves. Given this outline, the GOCR will have to decide whether and how to address the short-term issue of emergency gas reserves, and work with both the EU and the U.S. to approach Russia with dealing with the medium-term pipeline infrastructure issue and the long-term contractual commitments issue. Bartuska remarked that no matter who is in government, the GOCR has little choice in what it needs to do to address its energy security vulnerabilities, particularly in the short-term.

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